Submission No: 97

Submission of Arnold Bloch Leibler, Lawyers and Advisers to the Inquiry by the House of Representatives Standing Committee on Legal and Constitutional Affairs into the *Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004*

Table of Contents

1 Executive Summary 1
2 Introduction 2
3 The Taskforce Report 2
4 Outline of the Bill 4
5 The current legislation 6
6 "Tainted" purpose — the impossibility of rebutting the presumption 6
7 All "benefits", however insignificant, will be caught 10
8 "Tainted" property and "tainted" money — real world situations 10
9 Loans discharged by a bankrupt 13
10 Generous bankrupts who work for less than market rates punished 13
11 Orders in relation to "tainted" property or money are unjust and unrealistic 14
12 Spouses and partners of bankrupts 16
13 Why the Bill is contrary to public policy 17
14 Retrospectivity 20
15 Australian law in relation to foreign law 20
16 The "Dickensian" effect 21
17 What does the future hold if the Bill becomes law? 21
18 Arnold Bloch Leibler's recommendations 22

1 Executive Summary

1.1 The proposed amendments to the *Bankruptcy Act 1966* (Cth):

- are likely to act as a serious disincentive to investment and economic activity by the private sector;
- may lead to the transfer of wealth out of Australia to foreign jurisdictions;
- are the most serious infringement of civil property rights ever proposed to be enacted by the Commonwealth;
- are a grave over reaction to insignificant problems associated with a limited number of high net worth individuals evading tax;
- do not discriminate between a bankrupt whose estate is sequestrable because of the honest but negligent conduct of the bankrupt or others, and a dishonest bankrupt;

- favour the family of a bona fide divorced bankrupt in a property settlement over the family of a non-divorced bankrupt, and are otherwise unfairly discriminatory; (It may be the first piece of Commonwealth legislation that encourages divorce and property settlement purportedly in the best interests of the family);
- fall only marginally short of a reversion to the historically punitive bankruptcy regime captured in the novels of Charles Dickens;
- ignore the rehabilitative aspects of bankruptcy; and
- may jeopardise the enforceability of foreign judgments.

2 Introduction

2.1 This is a submission by Arnold Bloch Leibler to the inquiry by the House of Representatives Standing Committee on Legal and Constitutional Affairs into the Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004 ("**the Inquiry**"). It considers the exposure draft of the Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004 (Cth) released by the Attorney-General on 3 May 2004 ("**the Bill**").

2.2 This submission considers one of the terms of reference of the Inquiry, namely whether the Bill adequately addresses the issue of high income earners using bankruptcy to avoid paying debts that they can afford to pay, while continuing to enjoy a lifestyle made possible through the build-up of assets in the names of third parties. It focuses particularly on the proposed amendments to the *Bankruptcy Act 1966* (Cth) ("**the Bankruptcy Act**") which have stemmed from the Report[1]. The Taskforce Report was published in January 2002 by the Attorney-General's Department, the Australian Taxation Office ("**the ATO**"), Insolvency and Trustee Service Australia and the Treasury Department.

3 The Taskforce Report

3.1 The Taskforce Report recognised that **"a comparatively small number of taxpayers" were flouting their obligations to pay income tax**. Many if not all of the individuals the Taskforce was concerned with were NSW barristers who became bankrupt owing large amounts of income tax which was never recovered. The Taskforce Report concentrated on creating mechanisms that would prevent high-income tax debtors from using bankruptcy to avoid the payment of tax. It was recognised that the creditor in the majority of cases

[1] Report of the Joint Taskforce on the Use of Bankruptcy and Family Law Schemes to Avoid Payment of Tax (January 2002)("**the Taskforce Report**").

examined by the Taskforce was the ATO; indeed, in 90 per cent of the cases, the ATO was the sole or principal creditor.[2] Many of the recommendations made by the Taskforce resulted from what it described as the unique position the ATO holds as a creditor: unlike ordinary commercial creditors, it is does not "extend credit", nor is it able to withdraw its services if a debt is unpaid — it is only able to (retrospectively) collect a liability imposed by statute.[3]

3.2 When the Committee is considering whether the House should pass the Bill, it is crucial that the Committee take into account that the Government has said the Bill is responsive to a report that focused its attentions on the **recovery by the ATO of tax debts, and not on the reform of bankruptcy law generally**.[4] It is unarguable that the Bill goes well beyond the scope of the Taskforce Report. The far-reaching consequences (see further below) of the proposed amendments for bankruptcy and property laws, and the viability of conducting business in Australia if these laws were to be passed, must be fully and properly understood and assessed. At this stage, there has not been sufficient research, policy development or debate to justify the introduction of the Bill into Parliament. A wide-ranging and in-depth review which consults all stakeholders must be undertaken before the Government enacts such radical policy into law. Any attempt by the Government to reform the bankruptcy laws in a general way to specifically aid the ATO to recover tax debts must properly take into account the implications blanket reform would have on small and large businesses, corporate activity and the Australian economy.

3.3 The Taskforce Report considered various amendments to bankruptcy laws, additional to the amendments to Division 4A of Part VI of the Bankruptcy Act proposed in the Bill. The Bankruptcy Legislation Amendment Bill 2001 (Cth), if it had been passed, would have gone some way to preventing technically insolvent debtors with a capacity to pay their own debts from petitioning for their own bankruptcy. These amendments, which would discourage illegitimate repeat bankrupts and practically solvent individuals from petitioning for bankruptcy, are lamentably not incorporated into the Bill under consideration.[5]

3.4 The Taskforce Report noted that in the family law context, courts have "looked through" legal ownership of assets to protect a spouse's equitable or special

---

[2] Taskforce Report, Executive Summary, page 4, [1.4].

[3] See Taskforce Report, Executive Summary, page 5.

[4] Explanatory Memorandum, [2]; Taskforce Report, [4.4].

[5] Taskforce Report, [4.23].

interest in property.[6] Historically, bankruptcy legislation, however, does not allow the trustee (or a court) to "look through" ownership structures in the same way. In order to avoid abuses of the bankruptcy system, the Report said, "[t]his sanctuary needs to be addressed":

> "The bankruptcy law should not continue to shelter assets which, although held in other names ... may be under the effective control of the bankrupt ... or at the very least, were acquired either wholly or substantially, and directly or indirectly, through the bankrupt's endeavours or the application of the bankrupt's resources."[7]

3.5 It was suggested by the Taskforce Report that where a court did "look through" legal ownership structures in this way, the equitable or notional interest of a spouse or de facto partner should be taken into account in determining the property which vests in the bankruptcy trustee.[8] This recommendation, however, has not been carried over to the exposure draft (see further below). Nor is this suggestion an adequate answer to the problems thrown up by the Bill — it fails to protect the families of bankrupts, or other persons the bankrupt may have chosen to financially support, for instance elderly relatives or family with special needs.

4 Outline of the Bill

4.1 The Bill proposes, among other things, the insertion of a new Division 4A into Part VI of the Bankruptcy Act. The first object of the Bill is to

> "improve the ability of bankruptcy trustees to recover assets from bankrupts who do not own these assets personally but who have *funded the acquisition of assets* by third parties whilst retaining the use or benefit of those assets". [emphasis added] [9]

This object does not distinguish at all between a mere contribution, partial funding or whole funding by the bankrupt, or even third party funding guaranteed by the bankrupt. It is a glib statement that glosses over the complexities of real-life situations.

4.2 This object appears to be responsive to one of the Bill's stated policy objectives: "to address the issue of high income professionals using bankruptcy as a mean [sic] of avoiding their taxation and other obligations."[10] The amendments are said to be designed to "provide creditors with improved access to assets which are

[6] Taskforce Report, [4.27]–[4.37].
[7] Taskforce Report, [4.31].
[8] Taskforce Report, [4.32].
[9] Explanatory Memorandum, [3].
[10] Explanatory Memorandum, [9].

substantively those of the bankrupt but which are held in the names of other entities (such as the bankrupt's spouse or another family member)."[11]

4.3 The Bill should be consistent with the purpose of the Bankruptcy Act, that is, to administer the affairs of an insolvent person equitably, and distribute any divisible property among creditors. This of course does not preclude the insertion of mechanisms to promote the Bill's objects. But it does require that any re-distribution of assets which is contrary to existing principles of property law be equitable in the wider sense of that word — that is, no owner of property in law or equity, should have its property "confiscated" as a result of the bankruptcy of another person.

4.4 The Australian Law Reform Commission stated in its report following the *General Insolvency Inquiry* ("**the Harmer Report**"):

> There are two predominant principles which should govern the operation of insolvency law in the area of property. The first is that it should, as far as possible, be consistent with general principles of property law. Thus, the estate of the insolvent should encompass only property that was the insolvent's at the time of the formal commencement of the insolvency. The second principle is that the claim to title in property and the right of the administrator to control that property should be not better or worse than that of the insolvent."[12]

This submission urges the Committee to keep at the forefront of its consideration of the Bill the principles identified by the Harmer Report, principles that remain as relevant today as they were in 1988. These principles are not radical. They are predicated on notions of equity, fairness and certainty. If those principles have worked well for hundreds of years, why change them?

4.5 Furthermore, the constitutional validity of the Bill is doubtful. The Bankruptcy Act is enacted under section 51(xvii) of the *Commonwealth Constitution*, the banking and insolvency power (and other heads of power, such as the "incidental" power). The bankruptcy power has been interpreted to permit the Commonwealth, via a bankruptcy trustee, to divest the bankrupt of his or her assets.[13] Divesting a third party of legitimately acquired assets may not fall within the scope of the bankruptcy power as it has been interpreted by the High Court.

[11] Explanatory Memorandum, [9].

[12] Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) vol 1, [824] ("**the Harmer Report**").

[13] *R v Federal Court of Bankruptcy; Ex parte Lowenstein* (1938) 59 CLR 556, 575 (Starke J).

5 The current legislation — Rehabilitative; Generally fair; Certain.

5.1 The Bankruptcy Act already provides that any transfer of property by a bankrupt with the intention to *defeat* creditors is liable to be set aside. The *Statute of Elizabeth*, enacted in 1571,[14] provides that any alienation of property made with intent to *defraud* creditors is "clearly and utterly" void. The modern reincarnation of this provision is found in various State statutes, including the *Property Law Act 1958* (Vic), which provides that "every alienation of property made ... with intent to defraud creditors, shall be voidable, at the instance of any person thereby prejudiced."[15]

5.2 Section 120 provides that subject to certain exemptions, a transfer of property by a person who later becomes a bankrupt to another person is void against the trustee if the transfer took place within five years of the commencement of the bankruptcy and the transferee gave no consideration or consideration less than the property's market value. If the transfer took place more than 2 years before bankruptcy, the transfer will not be void if it can be proven that the bankrupt was solvent at that time. Section 121 provides that a disposition of property made at any time, with the main purpose being to prevent the transferred property from becoming divisible among the bankrupt's creditors, and if at the time of the transfer the bankrupt was or was about to become insolvent, will be void against the trustee.

6 "Tainted" purpose — the impossibility of rebutting the presumption

6.1 The Bill proposes a scheme for the recovery of assets by the bankruptcy trustee that goes far beyond the current provisions contained in Division 4A of the Bankruptcy Act. Any or all property or money transferred[16] by the bankrupt to another entity

(1) less than 10 years before the commencement of bankruptcy, and

(2) where that entity is ***not*** able to prove that the bankrupt's main purpose in making the transfer was not to prevent the property or money from becoming divisible among the bankrupt's creditors, **or**

(3) if it can be reasonably inferred from all the circumstances that, at the time of the transfer, the bankrupt was, or was about to become, insolvent,

---

[14] 13 Eliz, c 5.

[15] Section 172(1).

[16] A transfer can be effected by a number of means, including a change of ownership and the declaration of a trust: s 139AB.

is liable to vest in the trustee.[17] The transferred property or money is said to be "tainted" and the bankrupt's purpose in making the transfer, is deemed presumptively to be a "tainted purpose".[18]

6.2 The onus for rebutting this presumption rests on the bankrupt. Although the Explanatory Memorandum states —

> "a bankrupt may of course be able to put forward evidence sufficient to rebut such a presumption"[19]

— there is no acknowledgment that this is a heavy, if not impossible, burden for any person to discharge. Once the trustee has made an allegation of improper purpose, a bankrupt will need to adduce evidence which demonstrates, on the balance of probabilities (i.e. the civil standard of proof), that at the time the bankrupt transferred certain property or money, his or her "main" purpose was a purpose other than to prevent money from potentially becoming divisible property in a bankruptcy.[20] In other words, the Court will be required to accept the word of a "bankrupt" on the issue of purpose. The likelihood of a court doing so, is remote. A mock cross-examination is provided by way of illustration:

Counsel: *You are the respondent in this application?*

Bankrupt: *Yes.*

Counsel: *And you were made bankrupt 6 months ago because you accrued liabilities greater than your assets?*

Bankrupt: *Yes.*

Counsel: *And your passport been taken?*

Bankrupt: *Yes.*

Counsel: *And you now cannot borrow money?*

Bankrupt: *Yes.*

Counsel: *You were also found by the Supreme Court to have acted in breach of your duty of due care and diligence as a director? Her Honour also rejected your evidence and dismissed your defence and cross-claim?*

Bankrupt: *Yes.*

---

[17] Section 139AFA.

[18] Transferring property or money to hinder or delay the process of making the property or money available for division among the bankrupt's creditors also amounts to a "tainted purpose": s 139AFA.

[19] Explanatory Memorandum, [50].

[20] The Court will be able to join a bankrupt as a respondent to an application by a trustee for recovery of "tainted property" or "tainted money": proposed section 139CA.

Counsel: *You say your purpose in transferring property nine years ago into a trust was not to defeat the claims of your creditors, but to make provision for your elderly mother?*

Bankrupt: *Yes that's true.*

Counsel: *Are you seriously suggesting that the Court should believe the word of an insolvent, lying bankrupt who has millions of dollars of assets over liabilities and is a disgrace within the business community?*

The credibility of the bankrupt would always be in issue, and their evidence would not likely be accepted by the Court, particularly on the crucial question of purpose.[21]

6.3 A bankrupt who has been prosecuted or convicted of offences, either civil or criminal, is even less likely to be believed. Furthermore, where a prosecution is pending against a bankrupt, the bankrupt may not want to run the risk of incriminating themselves in bankruptcy proceedings. And a dead bankrupt (aside from the fact that they will not be joined as a respondent to the proceeding) has no hope of rebutting the presumption that he or she transferred property or money for the main purpose of defeating the claims of creditors. There is likely to be no other person who was aware of the bankrupt's purpose in making the dispositions of property under challenge. The only evidence a bankrupt may be able to put before a court of his or her intention may be the bankrupt's verbal assurance that particular property was not transferred for a "tainted" purpose. Even where a person contemporaneously records the reason for transfer, it is not difficult to foresee that the bankrupt's actions would be liable to be impugned on the ground that the record was not *bona fide* and was primarily brought into existence for the purpose of counteracting the effect of proposed section 139AFA. Moreover, a clever advocate will contend that if it was important to record purpose, then it had probably been apprehended that purpose may ultimately prove problematic. This will raise in a judge's mind the question of whether the bankrupt was aware that he or she was acting with a "tainted" purpose.

6.4 People transfer money or property into different entities for many reasons: to provide for dependents in the future (partners, children, grandchildren); to set up trusts for the care of the infirm, mentally ill relatives or the elderly; to establish

[21] Trustees in bankruptcy invariably make known to the Court that beneficiaries of claims are unsecured creditors. In reality, however, it is first the trustee who has priority, second its lawyers and then the ordinary unsecured creditors. More often than not, high net worth individuals establish trusts for the benefit of their family. The proposed amendments do not deal with the rights, if any, of the entity whose assets are seized, to claim as an unsecured creditor. Presumably, the drafters intended that such entities not have any rights, however, it is not clear whether this has been considered.

new businesses; or to legitimately arrange their finances for legitimate tax reasons.

> *For example, a sole parent bankrupt may have established a trust for an autistic child, when the child was still very young. Eight years later, the bankrupt's trust is challenged in the courts, but the bankrupt passed away several years before, leaving the autistic child in the care of his grandparents (who knew nothing about the establishment of the trust). The needs of the child are provided for solely by income from the trust as his grandparents are not able to contribute financially.*

As there is no person available to give evidence of the bankrupt's intention, the trustee's allegation of "tainted" purpose will stand unchallenged and the potentially destitute, autistic child will have his welfare will put at risk, even though his parent made what seemed at the time to be unassailable arrangements for his future wellbeing.

6.5 The effect of this provision will be to divest individuals and their associates of property and money which had otherwise been dealt with in accordance with the law. Innocently made *ex gratia* payments to family trusts — payments made to benefit family members — will put at risk trust assets. A transfer will also be "tainted" if it reasonably can be inferred from all the circumstances that at the time of transfer the bankrupt was, or was about to become, insolvent. The knowledge of the transferee and the bankrupt will both be both relevant. Actual knowledge of insolvency is not required. Consequently, innocently made transfers, not done for the purpose of defeating a claim by creditors, or for the purpose of hindering or delaying a creditor's claim, will be subject to the proposed Division 4A processes.[22]

6.6 Certain types of transfers are exempted from the "tainted purpose" deeming provision. Transfers for full market value, if the transfer took place more than 10 years before bankruptcy or where the transferee did not know of the tainted purpose, are exempt from vesting in the trustee.[23] ("Under-value" transfers where the transferee was unaware of the likely insolvency of the bankrupt are not exempt transfers.[24]) It is improbable that section 139AFB will ever be used by a spouse or partner of a bankrupt because it is rare that such transfers will ever made be for full market value. This provision will work great injustice because of

---

[22] The insolvency requirement as an alternative basis for establishing a tainted purpose merely mirrors the present section 121 in the Bankruptcy Act.

[23] Section 139AFB.

[24] This flows from the application of sub-sections 139AFA(1)(b) and (5)(b).

its retrospective application.[25] All previous transfers by a bankrupt which were not made for full market value are now liable to be impugned by a bankruptcy trustee, even where they occurred more than 10 years ago. This undermines the certainty of property law and may well encourage all persons who have been the recipients of transferred property or money to remove it from the jurisdiction of Australian courts.[26] Indeed, the Bill will effect the most serious infringement of civil property rights ever proposed to be enacted by the Commonwealth.

7 All "benefits", however insignificant, will be caught

7.1 Section 139AG provides that where a bankrupt directly or indirectly derives a benefit from income derived from a property, the bankrupt is taken to have derived a benefit from that property. Therefore, the entirety of property from which a bankrupt only derives an insignificant benefit could be taken by the bankrupt's creditors. The failure of the drafters of the Bill to take into account the actual benefit derived by a bankrupt is a serious oversight and will create injustice and inequity. For example, if a bankrupt nine years ago transferred to his or her partner (for no consideration) title to a house which is now rented, any benefit that bankrupt now receives (or has received) from the rental income will render that property "tainted property".[27] The Bill also does not reveal how "indirect" a benefit can be for it to fall within this provision — a further source of uncertainty in the interpretation of the Bill.

8 "Tainted" property and "tainted" money — real world situations

8.1 Proposed sections 139AI and 139AJ should not be enacted in their present form. If a bankrupt is not able to prove that a transfer was not made for a "tainted purpose" (an extremely onerous burden to discharge, as discussed above), the transferred money or property, any replacement property and the proceeds of disposal of that property or money in the hands of another entity will be available to creditors of the bankrupt.

For example, a bankrupt set up a family trust from which income was applied to purchase assets his family could enjoy. These assets were in turn sold, and replacement assets bought. The bankrupt had occasional use of many of the items, although they were used primarily by his children and grandchildren. Subsequently, the bankrupt became personally liable for a massive damages order, as a result of a

[25] As to retrospectivity, see further, section 14 below.

[26] Any property bought with money, or the proceeds of the sale of the transferred property, or which can be traced to the original property, is also going to be caught by the proposed amendments: sections 139AB, 139AC, 139AD.

[27] Section 139AJ will make the rental property "tainted property".

breach of the duty of due care and diligence in his capacity as a director of a company. The other directors of the company did not have any assets within Australia. The Commissioner of Taxation issued proceedings against the bankrupt to recover several million dollars worth of tax that was unpaid by the company. The family trust assets mentioned were vested in the bankruptcy trustee to satisfy the company's tax debt.

8.2 A real-life example illustrates the injustice worked by the proposed amendments:

The case of Max Eise and the National Safety Council [28]

Max Eise was an unpaid, non-executive, part-time director of the National Safety Council in Victoria at the time that John Friedrich defrauded the Council and other creditors of well over $250m. The Commonwealth Bank brought proceedings against Friedrich and the directors of the Council. The proceeding was dismissed against all the directors, except for Eise. The Court held that while Eise was not guilty of fraud, Eise essentially failed to properly supervise Friedrich. The Court said that Eise was "duped" by Friedrich. The Court held Eise liable to pay to the Commonwealth Bank a little more than $95m. In the end, Eise was financially ruined by the court case.

It is one thing for someone in Eise's position to be bankrupted, ridiculed, held up to contempt, and suffer the loss of his or her reputation as a businessperson and member of the community, but it is quite another for assets a person has accumulated over a lifetime to be confiscated, including those lawfully belonging to family members of the bankrupt.

8.3 These are patently unjust scenarios, but ones which will arise if the Bill is passed. Directors of corporations may judge that remaining in their positions poses too great a financial risk to themselves and to their families. Creditors of corporations, including the Commissioner of Taxation, are aware that insolvency is always a risk and take action to limit their exposure to risk, for example by securing their debt, or in the Commissioner's case, by collecting taxation at regular intervals. This risk cannot be eliminated by simply allowing creditors to take property from which a bankrupt derives some benefit, even if only indirectly.

8.4 Take for example the case of a director who made a genuine mistake:

The director suggested that the company of which she is a director move into futures contracts, which it does. As a result, the company sustains losses of $300m. The entire board of directors is held liable for failing to safeguard against the losses, but

[28] *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 (Victorian Supreme Court, Tadgell J).

the directors' insurance only indemnifies them up to an amount of $100m. The directors are personally liable for the $200m shortfall.

Under current bankruptcy laws, the directors may take the view it is best to settle with their creditors, and choose to contribute their assets to the shortfall, in combination with an *ex gratia* payment from a family trust, thus avoiding the stigma of bankruptcy, and continuing to contribute to society. If the Bill is enacted, even if the directors take this approach, they may still be forced into bankruptcy so that their creditors can take any "tainted" property as well. The directors will not only be destitute, but their children and grandchildren who they have provided for, may also be left in poverty. In addition, the directors will face the stigma of bankruptcy, and will be unlikely to ever be in a position to make a valuable contribution to the community again. This example demonstrates that the rehabilitative goals of bankruptcy will be lost if the Bill become law.

8.5 Further examples are illustrative:

Take the example of Lloyd's Names. After the crisis a number of years ago, many Names chose to make payments to Lloyd's which were not less than the amount that could be recovered in a bankruptcy rather than suffer the stigma of bankruptcy. Financial near-disaster was averted, and Lloyd's "rehabilitated". If a similar situation were to arise in the post-Bill environment, many of the Names and their families would be ruined because all family assets could be seized by bankruptcy trustees. The uncertainty would make it impossible to "commercially" avoid a bankruptcy.

Another example: a major chartered accountancy firm collapsed and the partners were personally liable for the debts of, and claims against, the firm. Many had made ex gratia payments to family trusts. The accountants made payments to creditors which were not less than the amount that could be recovered in a bankruptcy, but avoided bankruptcy and they and their staff were able to continue in business. The accountants' families were protected. However, if the Bill came into effect, the accountants and their families would face ruin and the prospects of continuing any successful business after bankruptcy would be remote.

8.6 Small business people, including those whose businesses are incorporated, will not be exempt from the proposed amendments, and are unlikely to be in a position where they can decide to stop operating their business for fear that creditors may take their family home. For most, that is a risk they must take.

8.7 Superannuation payments and funds are also at risk. Currently, the interest of a bankrupt in a regulated superannuation fund, a public sector superannuation scheme, or an approved deposit fund does not form part of the bankrupt's

divisible property on bankruptcy,[29] except where the bankrupt's property in the fund exceeds the bankrupt's pension RBL,[30] calculated by reference to section 140ZD of the *Income Tax Assessment Act 1936* (Cth). Self-funded retirees may find their efforts at providing for their old age jeopardised.

9 Loans discharged by a family member

9.1 If a person or entity uses "tainted" property or money to discharge (in whole or in part) a loan which was used to pay (in whole or in part) for property the bankrupt benefited by, that property in its entirety is "tainted property".[31] The application of this provisions will cause gross inequity.

> *For instance, a bankrupt set up a discretionary trust which loaned money to an entity so that it could purchase a house. The house was purchased for $500,000, but only $50,000 was derived from a loan from the trust. The entity obtained the remaining $450,000 from another source not associated with the bankrupt. The bankrupt stayed in the house when travelling interstate for business.*

If section 139AK were to be enacted in its current form, the entire house could be found to be part of the bankrupt's estate, notwithstanding that it is not owned legally or beneficially by the bankrupt, and that only 10% of the property was paid for with "tainted money".

10 Family members who work for their family for less than market rates punished

10.1 Where a bankrupt supplies personal services to an entity for no remuneration or less than an "arm's length amount", any money or property the entity owns as a result of the supply of services by the bankrupt (directly or indirectly), and which the bankrupt benefits by, will be deemed to be "tainted".[32] This proposed section is particularly problematic.

> *Take the example where an Australian company operates mining operations. Some of the directors on the board have worked for less than "arm's length" remuneration for the company. The shareholders of the company are family trusts associated with each of the directors. The directors are held strictly liable for environmental damage caused by the mine even though the damage arose from an accidental spill as a result of a slip by a very junior employee, who, if he had followed written guidelines and onsite training, would not have done caused the spill.*

---

[29] Bankruptcy Act, section 116(2)(d)(iii).
[30] Bankruptcy Act, section 116(5).
[31] Section 139AK.
[32] Section 139AL.

Consequently, the assets of the family trusts are vested in each of the director's bankruptcy trustees because the directors had not always worked for arm's length remuneration.

11 Orders in relation to "tainted" property or money are unjust and unrealistic

11.1 Proposed subdivision C gives power to the Court to make orders about "tainted" property or money. A trustee can apply for orders any time within 6 years after the date of bankruptcy.[33] (This is the same period currently in Division 4A.) An application can be made even if the bankrupt has been discharged.[34] A bankrupt may be required to give evidence about, or retain documents in relation to, events that occurred 16 or more years ago. Human memory is notoriously inaccurate and the requirement that a person recollect such distant events is unduly onerous and unfair. Furthermore, the need to retain documents over such a length of time is not in keeping with document retention provisions under other statutes. For example, a person is generally required to keep business records for five years for taxation purposes.[35]

11.2 The Court can order an entity to sell property and to pay to the trustee "such proportion (which may be 100%) of the net proceeds of the sale as, in the Court's opinion, reflects the bankrupt's ultimate contribution (whether financial or non-financial)."[36] "Non-financial contribution" is not defined in the exposure draft, but appears to relate to work done by a bankrupt where he or she is not remunerated at market rates. It is not clear whether any equitable interest of the bankrupt acquired through contribution to a domestic relationship (e.g. under State property law as it applies to de facto relationships) is intended to be caught by this section.

11.3 Proposed section 139F sets out certain matters the Court must take into account when making an order under section 139D. The Bill prohibits the Court from taking any matters ancillary to the prescribed matters into account. The Explanatory Memorandum provides this justification:

> "The matters set out in section 139F are exhaustive. The provisions of proposed new Division 4A apply to a defined set of circumstances. The consideration by the Court of other, undefined, matters may undermine the provisions and the Government does

---

[33] Section 139A.

[34] Explanatory Memorandum, [70].

[35] The time period can be longer in certain circumstances, e.g. where a taxpayer extends the period of time within which the Commissioner can issue an amended assessment.

[36] Section 139D(3).

> not consider other matters to be relevant. The exhaustive nature of these matters is also designed to provide greater certainty for those utilising the provisions."

11.4 The matters which the Court must consider include the estate or interest of any other person in the property or money, the net worth of the entity, any hardship that might be caused to the entity or to creditors, the extent to which the market value of the property reflects the bankrupt's or any other person's contribution, the extent of the benefit the bankrupt or other entity derived from use of the property and the extent to which the property was available for the bankrupt to use. "Hardship" is a subjective question and an inappropriate basis for ordering an entity to relinquish lawfully acquired property. Nor should the Court look to the "hardship" a creditor may face and weigh this against that which a bankrupt or an associated entity may suffer.

11.5 The factors outlined above are all matters the Court must weigh up in the exercise of its discretion when deciding to make an order under sections 139D or 139E. The problem with this approach is that creates uncertainty, and not, as the Explanatory Memorandum suggests, certainty. The common law has evolved a set of rules to deal with property consistently so that a person can know what they do and do not own with certainty. To brush away these rules and substitute a general discretion to deal with property, is a wholly unsatisfactory response by Parliament. For example, a bankrupt may have established various trusts and corporations to hold property and money. It would be absurd if the beneficiaries of these entities had no way of determining in advance which of the entities were likely to be struck down by a court, and which would be permitted to survive in the event of bankruptcy, because such a decision was purely discretionary. Furthermore, by prescribing the matters the Court may take into account, Parliament may be unduly restricting the exercise of the Court's discretion and injustice may be the result.

11.6 The Government has not included in section 139F one consideration that is highly relevant: the conduct of the bankrupt which led to accrual of unpaid debt or debts. Generally, there are three types of bankrupts:

(i) "financially incompetent" bankrupts — they incur personal debt, and are financially unsophisticated;

(ii) "innocent bankrupts" — they become bankrupt as a result of their own acts or omissions, or the acts or omissions of others, perhaps because they are uninsured, or not sufficiently insured — they are not dishonest;

(iii) "dishonest bankrupts" — they become bankrupt through their own dishonest conduct, e.g. fraud, crime, tax evasion, breach of the *Corporations Act 2001* (Cth).

The Bill does not distinguish between financially incompetent, innocent or dishonest bankrupts. The moral culpability of the bankrupt in each case is clearly different and is a factor the Court should be able to consider when exercising powers which drastically affect the property rights of innocent third parties. It is one thing for a dishonest, disreputable person to suffer the consequences of an order under proposed Division 4A. It is entirely another for a merely incompetent, but bankrupt person and that person's family to be subjected to such draconian laws.

12 Spouses and partners

12.1 It is unclear how the proposed amendments will affect the priority accorded to property held on constructive trust for a partner in a de facto relationship where the non-bankrupt partner has made largely non-financial contributions, i.e. will equitable interests be defeated by the bankruptcy trustee's ability to take assets that the bankrupt has funded and subsequently derives a benefit therefrom. If the proposed amendments are not intended to deprive spouses or de facto partners of their interests in property or money which the bankrupt has financially contributed to, the position of single or unmarried bankrupts should be considered in light of the provisions of the *Sex Discrimination Act 1984* (Cth) which prohibit discrimination on the ground of marital status. It would be arguably unlawful for a court to allow a bankruptcy trustee to defeat the financial or legal arrangements of a single bankrupt but not a married bankrupt — to prejudice the beneficiaries of a trust because they are not married to a bankrupt but are associated with the bankrupt in another way would be unfair and inequitable.

12.2 The effect of the Bill could be to force families to contemplate divorce or property settlement to protect their assets or wealth. Schedule 2 of the Bill exempts property the bankrupt is required to transfer under an agreement pursuant to Part VIII of the *Family Law Act* from being divisible property under the Bankruptcy Act (e.g. property settlements, maintenance agreements). A spouse may obtain a more beneficial division of the family assets upon divorce than a court may allow under ordinary Division 4A bankruptcy proceedings where there is no divorce. This is an obviously objectionable outcome.

12.3 Another aspect of the Bill is inconsistent with the *Family Law Act*: because of the operation of section 139AL, if a bankrupt supplies personal services for less than arm's length value to an entity and subsequently derives a benefit from property which is obtained by the entity partly through the provision of the bankrupt's services, that property is "tainted" property. Under current bankruptcy laws, that property will not form part of the bankrupt's divisible property. If that entity is owned by a spouse, the bankrupt may only own a portion of that entity as the result of a property settlement. However, the proposed amendments may make the entire property liable to vesting in the bankruptcy trustee if the spouse and the bankrupt are married at the time of bankruptcy.

12.4 If the Committee is minded to recommend that any part of the Bill be enacted, to avoid the discriminatory consequences of the Bill, it should be amended so that on the date of bankruptcy, only 50% of the total assets, including any "tainted" property or money (insofar as these exist), be available to the bankruptcy trustee, regardless of whether the bankrupt is married, in a de facto relationship, single or otherwise. That is, what ought to happen is that property interests between bankrupts and their associates would be immediately altered as they would be at the date of separation under the *Family Law Act*.

13 Why the Bill is contrary to public policy

13.1 Property lawfully acquired by innocent parties could well be confiscated as a result of the honest but negligent conduct of a bankrupt. This would represent a substantial policy shift in property laws, and undermine the foundations of the notion of property itself. The Harmer Report made this observation in relation to a proposal to allow creditors to take income a bankrupt earned from a discretionary trust:

> "The principal objection is that it could constitute an unwarranted intrusion into the legitimate rights or expectations of other persons (including other beneficiaries and the settlor of a trust). Insolvency law has rarely gone to the extreme of altering essential legal relationships in such a manner. The proposal would require very narrow criteria to limit possible injustice."[37]

13.2 Unsecured creditors have never had an expectation that they would ordinarily be able to access property legitimately held by an associate of a bankrupt. The special case of the ATO and its present difficulties in recovering taxation debts from a relative handful of bankrupts can be addressed in a number of other ways

[37] Harmer Report, above n 12, [839].

— myriad options were identified by the Taskforce Report — without the need to resort to the wholesale demolition of property law and its division into legal and equitable interests. Indeed, the Harmer Report reached a similar conclusion:

> "... the most appropriate way of dealing with bankrupts who have access to the property of private companies or property held on trust is for the court to take that fact into account in determining the contributions from income which the bankrupt may be required to make to the estate. It is then unnecessary to appropriate property of the separate entity [or third party] except where the entity and transactions involving the entity are shams and can be dealt with at general law ..."[38]

13.3 The proposed amendments will also particularly affect professionals who are personally liable for orders for damages as a result of insurance policies that do not cover the damage. Professionals who utilise a partnership structure to conduct their business will be especially vulnerable to claims by creditors. Many professionals legitimately shelter their assets and incomes from liabilities, and not with the intention of defeating the attempts of the ATO to collect income tax. The Taskforce Report did not touch upon the legitimate practice of professionals structuring their financial affairs to avoid such claims. The proposed amendments will significantly and detrimentally impact upon persons who become bankrupt for reasons connected with their professional activities. Wealth a professional has accumulated over a lifetime could be put in jeopardy by one actionable mistake. Take the following example, comparing the current Division 4A regime, and the proposed regime:

> ***Current regime***
>
> *A solicitor conducted her practice in a partnership. A negligence claim was brought against her for which there was not full insurance indemnity. The solicitor settled with her creditors for not less than the amount that could be recovered in a bankruptcy, avoided bankruptcy, and remained in business. Her employees remained in employment.*
>
> ***Proposed regime***
>
> *In order to avoid bankruptcy and its resulting consequences for her family (and her partners), the solicitor sought to disclose all her assets and hired an expert accountant to assess the value of her assets. She asked the trustee of her family trust to distribute her expected income for the next 8 years and in addition contributed the majority of her assets, which included assets of the firm, to cover the claim. In order to avoid the effect of the proposed "tainting" provisions, the solicitor was left without any*

[38] Harmer Report, above n 12, [849].

personal wealth, and it was no longer viable for her to continue to practise as a solicitor.

The proposed amendments may similarly affect everyone: politicians, unionists, charitable workers, carers and more. In theory, everything that anyone has put aside for the protection of their family will be at risk.

A charitable worker who is sued, but uninsured, may put at risk their family's assets.

A personal carer who is found to be negligent when looking after an elderly patient may jeopardise their children's future well-being.

The assets of the family of a politician sued for defamation may also be at risk.

13.4 The background paper provided by the Committee, however, states that

> "the Government does not believe that these assets [the personal wealth of professionals] should remain protected where creditors' claims cannot be met from assets held in the bankrupt's name whilst the bankrupt continues to enjoy a lifestyle effectively funded by his or her own means. The bankruptcy system should not be the means by which a person can protect his or her wealth from business failure whilst creditors bear all the risk associated with that failure."

These comments echo the sentiments expressed in the Taskforce Report which was concerned that high-income individuals enjoyed a luxurious lifestyle but did not pay any tax — obviously a morally unacceptable state of affairs. The Taskforce Report did not link this anomaly with "business failure" and the Government's back-door attempt to place the legitimately structured affairs of professionals who practise in their own name at risk unfairly prejudices such individuals against other persons who are able to conduct their business without risk of personal liability. Moreover, shifting the risk inherent in business activities from creditors to the entrepreneur/risk-taker will put in jeopardy investment, both foreign and domestic, within Australia: the key to entrepreneurial endeavour is appropriate risk-taking. Encouraging economic activity requires a balancing of risk, and the reforms in the proposed Bill may undermine the balance already struck between the risks taken by investors and creditors. Moreover, the broader tax consequences of widespread business failure as a result of Division 4A-forced bankruptcies may well exceed any immediate benefits derived by the application of proposed Division 4A.

13.5 The Bill may encourage the proliferation of offshore structures for the primary reason that investors do not want to risk their personal and family wealth should a

business venture fail. Tax revenue will be directed overseas and, ultimately, Australia will suffer.

14 Retrospectivity

14.1 The Bill is intended to have retrospective effect. The Explanatory Memorandum states:

> "This retrospectivity reflects the policy underlying the amendments — namely, to challenge the legitimacy of asset protection upon bankruptcy. If these proposed amendments were not retrospective and applied only to bankruptcies and transactions occurring after commencement, it would it could [sic] be some years before they took effect. Moreover, the effectiveness of these provisions would be substantially undermined as individuals simply organised their affairs to avoid them."[39]

Notwithstanding that many statutes have retrospective effect, it is a basic tenet of the rule of law that legislation only have prospective effect. This principle aside, the passage quoted above contains an admission by the Government that it will be possible for individuals to avoid the effect of the proposed amendments. If such avoidance is indeed possible (and in Arnold Bloch Leibler's view, it is likely to be very difficult), the legislation will inflict the greatest detriment on bankrupts who transferred property or money before the passing of the Bill, and will, paradoxically, have the least effect on bankrupts who, in the future, arrange their affairs with the anti-avoidance provisions in mind. This outcome would significantly undermine the Government's rationale for proposing to introduce the Bill into Parliament.

15 Australian law in relation to foreign law

15.1 If proposed Division 4A is on Australia's statute books, the governments of like-minded foreign countries — the legislative, executive and judicial branches — may begin to view Australia's property laws with suspicion and hostility. Countries that have a common law tradition (the United Kingdom, New Zealand, Canada, the United States) may consider that the proposed amendments are anathema to the common law's development of property law and hence should not be enforced outside Australia, for example, by recognising and enforcing Australian judgments in common law countries. Courts will generally recognise the judgments of foreign courts as a matter of comity, but where they perceive the laws they are enforcing to be draconian and unjust, they may be hesitant to stamp the decisions of Australian courts with their own judicial "imprimatur".

---

[39] Explanatory Memorandum, [89].

15.2 Arnold Bloch Leibler is not aware of similar laws being enacted in any common law countries. If the Committee would be assisted by Arnold Bloch Leibler continuing to research these issues, then we will do so.

16 The "Dickensian" effect

16.1 The Bill seeks to punish a whole raft of innocent people: the elderly, children, students, persons with special needs, partners. It will often be impossible for bankrupts to rebut the presumption that they transferred property to defeat creditors, even though they may have structured their assets to provide their families with a certain level of comfort, and to provide for the continued wealth of future generations. Many bankrupts work for little or no reward — a hardly surprising proposition considering that many do so for the benefit of family or friends. Depriving them and their families of all the fruits of their labour is purely punitive: it harkens back to the times of Charles Dickens when debtors and their family members were thrown into prison until they could afford to pay their debts. What can such a Bill really have to do with the "handful" of barristers in New South Wales who refused to pay their tax?

17 What does the future hold if the Bill becomes law?

17.1 If the Bill becomes law, successful business people may, on advice, immediately withdraw from all activity that exposes them to risk, perhaps leading to a rush of early retirements. Given that Australia has an ageing population, the consequent burden on other taxpayers and State Governments and the Commonwealth will be significant. People will not undertake new ventures as readily as they do presently.

17.2 Individuals may take their assets (and those which could be deemed to be "tainted" assets) out of the jurisdiction of Australian courts so that they may be immune from the suit of a bankruptcy trustee.

17.3 There will be uncertainty in relation to securities: financial institutions will be less inclined to lend money, particularly where they are on notice that a person may have "tainted" property or money securing loans. Ultimately, the lending process will be more cumbersome and expensive.

17.4 The enactment of the Bill will lead to a plethora of litigation, as trustees and bankrupts seek to determine the scope of the law, and give content to undefined terms in the legislation. Constitutional challenges will probably be made. Trustees may not have the finances to fight expensive court cases.

17.5 Twenty million Australians will be significantly worse off so that 50 or so barristers will pay their tax.

18 Arnold Bloch Leibler's recommendations

18.1 The Government should contribute significant amounts to a fighting fund for bankruptcy trustees so that they can fully pursue their claims within the current legal framework.

18.2 If the Committee takes the view that the Bill should be enacted in a modified form, the presumption of tainted purpose should only apply to dispositions within 12 months of the commencement of bankruptcy. If the onus is reversed and placed on the bankrupt (which Arnold Bloch Leibler opposes), short and strict time limits must apply, forcing the trustee to deal with any applications expeditiously.

18.3 Alternatively, the proposed Division 4A regime should only apply to bankrupts against whom a finding of dishonesty has been made in a superior court.

18.4 The problem addressed by the Taskforce is one which may be better solved by creating "bankruptcy-in-perpetuity" for persistent debtors who appear to have an ability to pay their debts, for example, because they continue to work and earn an income.

We would be happy to make oral submissions if that is of further assistance.

18 June 2004

Arnold Bloch Leibler
Lawyers and Advisers

Level 21, 333 Collins St
Melbourne VIC 3000

Phone: 03 9229 9999
Fax: 03 9229 9900

Contact:

Leon Zwier
Partner
LZwier@abl.com.au